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STATE FOR WHA/CAR (WBENT), WHA/EPSC (JSLATTERY)

SANTO DOMINGO FOR FCS AND FAS

TREASURY FOR L LAMONICA

E.O. 12958: NA
TAGS: ECON EFIN JM
SUBJECT: JAMAICAN CURRENCY UNDER PRESSURE

¶1. (U) Summary: The Jamaican dollar is facing its biggest test following a prolonged period of stability dating back to early 2003. Foreign exchange market instability emerged during September 2005, prompting the Bank of Jamaica (BOJ) to institute new measures aimed at identifying and blacklisting speculators. However, the measures have drawn the wrath of some foreign exchange dealers who are of the opinion that the depreciation is being driven by demand pressures for U.S. dollars to buy GOJ bonds. Inflationary pressures, increased Jamaican dollar liquidity and seasonal demand for foreign exchange have also provided additional impetus for the depreciation. The declining supply of foreign exchange reflects flat tourism earnings and lower goods exports have also impacted the market. The instability could be halted in upcoming weeks as supply increases on the back of higher bauxite/alumina exports and increasing FDI. The BOJ also has the alternative of hiking interest rates, but this option could have an adverse effect on fiscal policy. End summary.

Bank of Jamaica stabilization efforts

¶2. (U) The Jamaican dollar has depreciated by four percent since June 2005, after trading at around USD 1 to JMD 61 for the last two years, the longest period of stability in a decade. Signs of instability emerged in the foreign exchange market during September 2005, prompting the Bank of Jamaica (BOJ) to convene a meeting with foreign exchange dealers to discuss strategies to stabilize the currency. Despite the use of moral suasion and the selling of funds from the Net International Reserves (NIR) to temper the demand pressures, the currency continued to depreciate, trading as high as USD 1 to JMD 64.5 in October. This forced the BOJ to convene a second meeting on October 19 to institute measures aimed at identifying pure speculators to segregate them from the real users of foreign exchange. One foreign exchange dealer at local firm Mayberry Investments told emboff that based on the new rules only buyers who could prove they were carrying out legitimate business would qualify for funds sold to the market by the BOJ. As a consequence, prospective buyers considered to be speculators by the BOJ would be denied supply-side intervention funds, creating a de facto blacklist.

¶3. (SBU) However, this latest BOJ measure has drawn the ire of foreign exchange dealers. Former President of the Securities Dealers Association and CEO of Alliance Investment Management, P.D. Chin, told emboff that the BOJ must be realistic as the depreciation reflects market sentiment rather than speculation. "If I am in the market I am going to take a position in U.S. dollars and you can call it speculation if you want to," Chin stated. "We are badly overvalued and the market must correct itself. In addition, people have been coming out of Jamaican dollars to buy the USD bonds issued recently," Chin continued. The evidence appears to support Chin's assertion, as the GOJ has issued two bonds worth over USD 300 million in less than two months. While USD 250 million of this amount was raised on the international capital market (primary market), Jamaicans have purchased over 60 percent of these issues on the secondary market. The redemption of a U.S. dollar indexed bond (USD 46.7 million) on October 4 provided additional demand pressures as investors converted their Jamaican dollars to U.S. dollars.

External Factors

¶4. (SBU) The build up in inflationary pressures has also provided some impetus for the slide in the currency. Inflation of 2.6 percent in September has brought overall price increases for the April to September period to 11.8

percent or 2.8 percentage points above the target for the full fiscal year. Investors who are receiving real negative returns on their local investment are therefore realigning their portfolios by switching to U.S. dollars. Increased liquidity in the money market due to maturing debt instruments has also provided substantial resources to build up demand pressures for U.S. dollars. In addition, some investors are anticipating an upward adjustment in interest rates to reflect the surging inflation, but Director of Research and Publications at the BOJ, Louise Brown, told emboff that the bank would resist this move as it has not worked in the past. Additional pressures have also stemmed from the seasonal demand of industrial and commercial users to purchase goods for the Christmas season.

¶5. (SBU) While most of the recent pressure on the local currency has been demand driven, there has also been some weakness on the supply side. In particular, the economy is going through its traditional "tamarind season" when foreign exchange inflows tend to be low. The seasonal falloff in foreign exchange inflows, which is more pronounced this year due to flat tourism revenues and declining goods exports, has consistently led to slippages in the local currency. The only aberration occurred in 2004 when speculators were recovering from the heavy losses inflicted by the intervention of the BOJ during 2003, which led to an appreciation of the local currency. When asked about the prospects for the foreign exchange market, Brown told emboff that the market was settling down due to the ongoing supply-side interventions, but speculators were still lurking around to capitalize on weaknesses that might appear. Brown said that the inflation rate, oil prices and the weather were the bank's main concerns. "We cannot wait until the hurricane season comes to an end," Brown concluded.

¶6. Comment: The pressure on the local currency could be arrested in upcoming weeks, given a jump in bauxite and alumina export earnings as well as the expected uptick in remittances for the Christmas season. The start of the winter tourist season, increasing FDI and external loan inflows will also improve supplies and bring some order to the foreign exchange market. The BOJ is also in an improved position to make supply-side interventions given the record build up in the stock of NIR to over USD 2.2 billion in October. As a last resort, the BOJ also has the option to increase interest rates to remove Jamaican dollars from the market. However, while this is an effective tool of monetary policy and might scare speculators away for a long time, higher interest rates would have serious implications for the GOJ. In addition to reversing the downward trend in interest rates, it would lead to higher domestic debt servicing costs, which are already running ahead of target. This could derail the country's financial program, as the GOJ would not be able to meet most of its targets, chief among them the balanced budget objective. This may trigger a decline in confidence among investors in general and external investors in particular, leading to renewed instability in the foreign exchange market. End comment.

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